89-1503

NO.

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

PHILADELPHIA STOCK EXCHANGE, INC.,

Petitioner,

v.

CHICAGO MERCANTILE EXCHANGE,
BOARD OF TRADE OF THE CITY OF CHICAGO,
SECURITIES AND EXCHANGE COMMISSION,
THE INVESTMENT COMPANY INSTITUTE,
THE OPTIONS CLEARING CORP.,
AMERICAN STOCK EXCHANGE, INC.
and CHICAGO BOARD OPTIONS EXCHANGE, INC.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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Question Presented

Did the Court of Appeals err in drawing a line between the jurisdiction of the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission, based on an unlimited definition of "futurity", which encompasses all instruments where realization of value is delayed, even by as little as one day, thereby denying the SEC its Congressional grant of jurisdiction over innovative securities instruments?

List of Parties

The parties to the proceeding in the court whose judgment is sought to be reviewed are:[1]

1. Petitioner Philadelphia Stock Exchange, Inc.[2]
2. Respondent Chicago Mercantile Exchange.
3. Respondent Board of Trade of the City of Chicago.
4. Respondent Investment Company Institute.
5. Respondent Securities and Exchange Commission.
6. Respondent The Options Clearing Corporation.
7. Respondent American Stock Exchange, Inc.
8. Respondent Chicago Board Options Exchange, Inc.

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[1] The Commodity Futures Trading Commission was not a party to the action below, but did file a brief as *amicus curiae* in support of the petition for review sought by respondents Chicago Mercantile Exchange and Board of Trade of the City of Chicago.

[2] The stock of petitioner is not publicly traded and control of petitioner is vested in its members. The subsidiaries of petitioner (other than wholly-owned), as defined in Supreme Court Rule 29.1, are the Center for Currency Options, Inc. and the Philadelphia Board of Trade, Inc.

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Respondents.

PETITION FOR A WRIT OF CERTIORARI

Petitioner respectfully requests that a writ of certiorari be issued to review the decision and judgment of the United States Court of Appeals for the Seventh Circuit entered on August 18, 1989, which set aside two related orders of the Securities and Exchange Commission. The two orders approved, respectively, rules changes by petitioner that provided for the trading of an investment instrument called a Cash Index Participation and rules changes by respondent The Options Clearing Corporation that provided for the issuance and clearing of transactions in the Cash Index Participation.

Opinions Below

The opinion of the Court of Appeals (reproduced in the Appendix at A1),[1] including the Court of Appeals' opinion on denial of rehearing and rehearing en banc (reproduced in the Appendix at A108), is reported at 883 F.2d 537. The orders of the Securities and Exchange Commission set aside by the Court of Appeals are contained in Securities Exchange Act Release No. 26709 (54 Fed. Reg. 15,280) (reproduced in the Appendix at A26) and Securities Exchange Act Release No. 26713 (54 Fed. Reg. 15,575) (reproduced in the Appendix at A84).

Jurisdiction

The judgment of the Court of Appeals was entered on August 18, 1989 (A1-25). By order and opinion dated October 23, 1989, the Court of Appeals denied a timely petition for rehearing and suggestion for rehearing en banc (A108-111).[2] On January 17, 1990, this Court granted petitioner's application (Application No. A-513) for an extension of time to file this petition, and extended petitioner's time to file this petition to March 26, 1990. This Court has jurisdiction to review the judgment of the Court of Appeals by writ of certiorari pursuant to 28 U.S.C. § 1254(1)(1988).

Constitutional and Statutory Provisions Involved

This case involves Section 2 of the Commodity Exchange Act, as amended (7 U.S.C. §§ 2, 2a (1988)) and Sections 3(a)(10) and 25(a) of the Securities Exchange Act of 1934, as amended (15 U.S.C. §§ 78c(a)(10), 78y(a) (1988)).

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[1] Prior to the filing of this petition, respondents The Options Clearing Corporation (the "OCC"), American Stock Exchange, Inc. ("AMEX") and Chicago Board Options Exchange ("CBOE") filed a joint petition for a writ of certiorari in this action. Pursuant to the instructions of the Clerk of this Court, petitioner and OCC, AMEX and CBOE have jointly prepared an appendix that has been filed with the OCC, AMEX and CBOE petition and is incorporated herein by reference. Pages of the appendix shall be cited herein as "A___".

[2] Two judges of the Court of Appeals, Judges Cudahy and Ripple, voted in favor of rehearing en banc. A110-11.

The pertinent portions of these provisions are reproduced in the Appendix at A119-21.

Statement of the Case

On April 11, 1989, the Securities and Exchange Commission (the "SEC") issued an order approving an application of petitioner Philadelphia Stock Exchange, Inc. ("PHLX") to list and trade an instrument known as the Cash Index Participation (the "CIP").[3] A84-107. The SEC simultaneously issued an order approving the application of the OCC to act as issuer and clearing agent for the CIP. A108-111.

The CIP was a new and unique instrument, designed to allow investors to obtain the benefits of owning a diversified portfolio of stocks without requiring them to incur the substantial transaction costs of obtaining each stock in the portfolio. A68-70. The CIP was also seen as filling a need, identified by several commissions established in the aftermath of the October 1987 stock market crash, for a "market-basket" security that would help reduce the price volatility and market uncertainties caused by trading between stock index futures and the component stocks of the underlying index. A67-68.

The CIP was an instrument of perpetual duration that allowed an investor either to buy or sell the equivalent of a market basket of stocks, represented by an "index" of underlying stocks,[4] by taking either long or short positions in the CIP. A2-3. The purchaser or "long" would, upon opening his position, pay to the seller or "short" the full purchase price of the CIP. In return for the payment of the purchase price, the long would receive certain rights under the CIP,

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[3] The SEC's order also approved the listing and trading of similar instruments by respondents AMEX and CBOE called, respectively, Equity Index Participations and Value of Index Participations. The Court of Appeals referred to the CIP and the other similar instruments by the generic term "Index Participation" or "IP". A2.

[4] There were two CIPs representing two different indexes of stocks: the S & P 500 CIP represented the Standard & Poor's 500 Stock Index, and the Blue Chip CIP represented an index of designated high capitalization blue chip stocks. A32-33.

including the right to receive quarterly dividend-equivalent payments equal to the regular cash dividends that would be received by a holder of the stocks that composed the CIP index and the privilege to exercise a "cash-out" under which the long could, on a daily basis, elect to liquidate his position in return for 99.5% of the value of the underlying index, as of the close of business the following day.[5] A27-28. Although the long did not possess any voting rights, the CIP was designed to replicate all the economic characteristics of the ownership of a portfolio of stocks. A27, 49-50.

The short had obligations that were a mirror image of the long's rights. In return for receiving the full purchase price of the CIP upon opening his position, the short undertook to make dividend equivalent payments to the long and to pay 99.5% of the value of the underlying index (or 100% if exercise occurred on the designated day each quarter) to a long exercising the cash-out privilege. A38-39. Each time a long exercised his cash-out privilege, a short would be chosen to pay the value of his position to the long. A4, 31.

CIPs would be traded daily on the floor of PHLX. Thus, both the long and the short could also liquidate a position by trading. The short would purchase a CIP, thereby cancelling out the original short position, or the long would sell a CIP, thereby cancelling out the original long position. A4.

The CIP, however, was never given a fair chance to prove its utility in the marketplace. Immediately upon its approval, respondents Chicago Mercantile Exchange ("CME") and Board of Trade of the City of Chicago ("CBT") filed a Petition for Review in the United States Court of Appeals for the Seventh Circuit pursuant to Section 25(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), 15 U.S.C. § 78y(a) (1988), asking the Court of Appeals to set aside the SEC's orders and to block the trading of IPs on any exchange. A5. The CME and CBT

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[5] Once each quarter, there was a designated day on which a long could cash-out for the full value of the underlying index. A27-28. The AMEX and CBOE instruments provided only a privilege to cash-out once each quarter or semi-annually, and not for a daily cash-out. A28-30.

took the position that, even though the CIP was explicitly designed to replicate the economic characteristics of stock ownership, the CIP and similar instruments should be regulated by the Commodity Futures Trading Commission (the "CFTC"), rather than by the SEC, the agency that regulates stock transactions.[6] A5.

The United States is unique among market economy countries in dividing responsibility for regulating financial instruments between two agencies. The SEC regulates the trading of securities pursuant to the Exchange Act, and the CFTC regulates futures contracts pursuant to the Commodity Exchange Act of 1974, as amended (the "CEA"). 7 U.S.C. § 1, *et seq.* (1988). It has been argued that this division of regulatory authority fosters competition among financial markets and serves the interest of the investing public. A13. However, as the Court of Appeals recognized in this action, this divided authority can be used by one segment of the financial industry to veto innovations proposed by another segment of the industry. A22. Although no instrument like the CIP has ever been proposed for trading on a futures exchange, either before or after the Court of Appeals' decision, the CME and CBT took the position that such an instrument could not be offered to the public by a securities exchange. A6.

The Court of Appeals determined that the CIP was, in fact, a new type of instrument that did not fit precisely within the definition of either a security or a futures contract. "We must decide whether tetrahedrons belong in square or round holes." A2. However, the Court of Appeals, taking a broad view of the CFTC's jurisdiction over futures contracts, then determined that any instrument containing

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[6] Respondent Investment Company Institute (the "ICI") also filed a Petition for Review, arguing that the CIP, although properly within the SEC's jurisdiction, constituted shares in an investment company as defined in the Investment Company Act of 1940, as amended (15 U.S.C. § 80a-1, *et seq.* (1988)), and had not been properly approved in accordance with that act. A5. Because the Court of Appeals held that the CFTC was the proper regulatory authority for the CIP, the court had no occasion to rule on the issue raised by the ICI. A25.

an element of futurity, as expansively viewed by the Court of Appeals, is subject to the CFTC's jurisdiction, in spite of the instrument's fundamental security characteristics. A22.

Consistent with the unbalanced deference that it accorded to the CFTC's jurisdiction, the Court of Appeals held that the CIP possessed "futurity" because the holder of a CIP does not have the right to realize the value of his investment instantaneously. A17. Consequently, PHLX was compelled to halt trading in the CIP, and the investing public was wrongly deprived of the benefits of an innovative and useful instrument. A25.

Reasons for Granting the Writ

The net effect of the Court of Appeals' decision is to call into question whether any new and innovative financial products can be developed by or traded on securities exchanges and, in many cases, be traded at all in the United States. The Court of Appeals' deference to CFTC jurisdiction, combined with its overbroad definition of futurity, has created a situation where any financial instrument that is not precisely identical to instruments already traded on securities exchanges will likely be found to possess the element of futurity and therefore placed under CFTC jurisdiction. Thus, securities exchanges, such as PHLX, will be wrongly denied the ability to participate in the development of innovative financial instruments, and the public will be denied the benefit of market innovation that is sorely needed.

The CEA contains a very broad definition of the term "commodity", and requires that contracts for "future delivery" of a commodity be traded exclusively on markets designated by the CFTC. 7 U.S.C. §§ 2, 2a (1988). As a result, under the Court of Appeals' expansive definition of futurity, almost any transaction, regardless of the item traded, can be found to possess futurity, if delivery of the item does not occur instantaneously. *See* A16. The broad definition of the term commodity contained in the CEA, combined with a broad definition of the term futurity, as put

forward by the Court of Appeals, could transform most commercial transactions into contracts for the future delivery of a commodity that can only be traded on futures exchanges. *See* 7 U.S.C. §§ 2, 2a (1988).

Therefore, viewing the Court of Appeals' decision with the broadest possible scope, the decision calls into question the continued viability of flourishing financial markets, always thought to be beyond the scope of the CEA, since they could now be viewed as nothing more than illegal futures exchanges. At a minimum, the Court of Appeals' decision effectively destroys the ability of these markets to meet investors' developing needs because any new instruments developed will be found to possess futurity, as defined by the Court of Appeals. Indeed, the Court of Appeals implicitly recognized that its decision gives one segment of the financial industry (futures exchanges) the power to destroy useful products (such as the CIP) for reasons having nothing to do with the new product's ability to survive in a free and competitive marketplace and to serve the needs of the investing public. A22.

It was clearly never Congress' intent, in dividing jurisdiction between the SEC and CFTC, that all financial innovation be entrusted to the CFTC. Yet, if the Court of Appeals' decision is allowed to stand, such a result is almost inevitable.

I. The Seventh Circuit's Decision Has Erased Any Meaningful And Principled Distinction Between Futures Contracts And Securities

Central to the Court of Appeals' finding that the CIP falls within the exclusive jurisdiction of the CFTC was the court's determination that the CIP possessed the element of futurity. A17. By virtue of its decision, the Court of Appeals, in effect, has held that any investment instrument whose value cannot be realized until a future time possesses futurity and therefore is a "futures contract".[7] The Court of

[7] The Court of Appeals also stated that the CIP looked like a security to a long, but looked like a futures contract to a short. A3. That observation was mistaken. In fact, a short on the CIP is fundamentally in the same

(footnote continued on next page)

Appeals held that the CIP had the characteristic of futurity because, although the CIP long discharges all his obligations under the CIP contract upon purchasing the CIP, the long cannot compel a short to pay him for the value of his position until a future cash-out date. A16-17.

However, futurity, as defined by the Court of Appeals, could be ascribed to virtually any financial instrument traded in an active market. Indeed, stocks, bonds and many other investment vehicles, which are concededly not futures contracts, carry with them no right to the current value of the instrument and allow an investor only the right to realize the value of the instrument on a future date. Thus, the Court of Appeals' definition eliminates any distinction between a futures contract and a security, and leaves nothing that can be called solely a security.

Given the Court of Appeals' infinite expansion of the concept of futurity, literally any security or investment could be said to possess futurity and be categorized as a futures contract. For instance, the holder of stock has no right to compel anyone, including the company whose stock the investor owns, to pay him the current value of the stock

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(footnote continued from preceding page)

position as a short-seller of stock, who borrows stock from a third-party, and not a short on a futures contract. The short-seller of stock must make dividend equivalent payments to the lender of the stock, *see* F. Fabozzi & F. Zarb, *Handbook of Financial Markets: Securities, Options, Futures* ("Fabozzi & Zarb") at 283-84 (1981), just as a CIP short makes these payments to the long. A short on a futures market makes no such payments. 1 P. Johnson & T. Hazen, *Commodities Regulation* ("Johnson & Hazen") § 1.10 at 41 (2d ed. 1989) (title to underlying commodity does not pass at opening of position). Likewise, a short-seller of stock receives full payment for the stock when the sale occurs (subject to a settlement period), Fabozzi & Zarb at 283-84, just as a CIP short receives full payment for his position on the day it is open. Payment on a futures contract short position is made on the day of delivery, when the contract expires, not on the day the position is opened. 1 Johnson & Hazen §1.17. Consequently, to the extent that the Court of Appeals based its decision on the perception that a CIP short was in the same position as a futures contract short, the Court of Appeals erred.

upon his demand. A9.[8] The stockholder must either trade out of his position, through a sale to another party on some date subsequent to the stock's acquisition, or alternatively wait for the future liquidation of the company to enforce his rights to the stock's current value. Consequently, under the Court of Appeals' definition, stock manifests the same element of "futurity" as a futures contract or a CIP. A16 ("[n]either the long on the IP nor a long on a futures contract can compel the short to *pay* current value . . . ." (original emphasis)).

The illogic of the Court of Appeals' definition of futurity is, however, best illustrated by its treatment of the CIP daily cash-out provision. Unlike the other IP instruments considered by the Court of Appeals, the CIP allowed a long to cash-out on a *daily* basis, not quarterly or semi-annually; thus, in addition to the ability to liquidate the position on the trading floor, a long could exercise his cash-out rights immediately after establishing his position. A27-28.

In its decision denying a rehearing, the court quoted from PHLX's reply brief in opposition to the CME's and CBT's Petition for Review:

> [I]t is important to note that [the CIP] has a daily, not quarterly, cash-out provision. Therefore, assuming *arguendo* as true the CME's and CBT's notion that a quarterly cash-out carries with it an element of futurity, a daily cash-out cannot be equated with a futures contract's quarterly expiration. Even in a stock transaction, the settlement period for delivery of the stock is 5 days. A daily cash-out, which is a feature unique to [the CIP], eliminates any element of futurity.

A110. Even the CFTC has, at times, recognized that a short delay in realizing the value of an instrument does not constitute futurity. *See* CFTC Office of the General Counsel,

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[8] Indeed, a transaction on the New York Stock Exchange ("NYSE") involves a settlement period of up to 5 days. NYSE Rule 64. Thus, a purchase of stock actually calls for delivery on a date in the future every bit as much as the daily cash-out of the CIP.

Interpretative Letter No. 85-2, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,673 at 30,857 (Aug. 6, 1985) (determining that certain bank transactions lack the "element of futurity", even though the transactions involve transfer of title two days after the initial transaction). Yet, the Court of Appeals improperly concluded that the daily cash-out provision also possessed futurity.[9] A110.

If the concept of futurity is to result in a principled distinction between futures contracts and stock and other securities, there is an essential characteristic that the Court of Appeals must have omitted from its stated definition of futurity. Although the Court of Appeals held otherwise, it has always been part of the traditional and accepted definition of a futures contract that they are *bilateral* contracts. That is, that futures contracts do not defer the exercise of some rights to a future date (as do stocks and CIPs), but that futures contracts defer the accrual of *all* rights and obligations, both on the short and long side, to a fixed future date:

> Futures trading occurs in *executory contracts* as yet uncompleted, representing an exchange of mutual promises to conclude a sale later on specific terms. Acquisition of a futures contract, therefore, leaves title and ownership of the underlying commodity exactly where it was before the contract was entered. Title will not pass unless and until the futures contract is fully performed by both parties: the seller by delivering what he has promised; the buyer by tendering the *full* purchase price.

I Johnson & Hazen § 1.10 at 42 (original emphasis).

The Court of Appeals conceded that CIPs were not bilateral, but rejected the argument that futurity combined with

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[9] The Court of Appeals so concluded solely because the daily cash-out occurs at 99.5% of index value, rather than 100%. A110. This is a distinction without a difference. If PHLX had set the value of the CIP at 50% of index value it would still represent a *present* interest, regardless of the amount. Quarterly cash-out at 100% of index value is better viewed as a premium paid to encourage investors to utilize market transactions (at full index value) rather than utilizing the daily cash-out. A27-28. It is therefore wrong to call the daily cash-out a "cash-out at a penalty." A110.

bilateralism is the defining characteristic of a futures contract. A16-17.[10] In so doing, the Court of Appeals effectively transformed virtually all financial instruments into futures contracts, thereby stripping the SEC of its jurisdiction over new financial instruments and transferring all jurisdiction over such instruments to the CFTC. The Court of Appeals erred in abandoning the proper definition, which, if applied, would have required affirmance of the SEC's order authorizing CIPs.

II. Congress Intended That Securities Exchanges Play A Role In The Development Of Innovative Financial Products

There is no statutory definition of a futures contract. *See* 7 U.S.C. § 2 (1988). Nonetheless, use of a definition of futurity that frustrates Congressional intent is certainly neither justified nor proper. Here, that is exactly what happened. The Court of Appeals adopted a definition that is so broad that it denies the SEC its Congressionally mandated right to oversee the development of innovative securities instruments.

Congress has vested both the SEC and CFTC with jurisdiction over different types of financial instruments: securities and futures contracts. In so doing, Congress has

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[10] The Court of Appeals' rejection of bilateralism is especially curious because, prior to this decision, the CFTC had always taken the position that bilateralism was an essential element of a futures contract. In a report to the Senate Agriculture Committee, dated May 16, 1989 (the "CFTC Report", which was accepted into the record by the Court of Appeals as a publicly available document (A7)), the CFTC addressed the question of CIP jurisdiction. In response to the SEC's assertion that a CIP lacked bilateralism, the CFTC identified bilateralism as "a second essential element of a futures contract . . ." and attempted to show how the CIP was a bilateral contract. CFTC Report at 10. The CFTC reiterated this point to the Court of Appeals in its *amicus* brief.

In its decision, however, the Court of Appeals correctly held that the CIP lacked bilateralism. A16. Nevertheless, rather than deferring to the CFTC's well-established definition, as it should have, the Court of Appeals chose to abandon it and to apply a boundless definition of futurity that permitted the Court of Appeals to find that a CIP was subject to CFTC jurisdiction. A16-17.

expressly preserved the authority of the SEC to maintain jurisdiction over securities and the development of innovative securities instruments.[11]

Conflicts between the SEC and CFTC over stock-index based instruments have arisen in the past, and Congress has acted to maintain the balance between the SEC and the CFTC. A11-13. In the aftermath of *Chicago Board of Trade v. SEC*, 677 F.2d 1137 (7th Cir.), *vacated as moot*, 459 U.S. 1026 (1982), Congress addressed the jurisdictional conflict between the SEC and CFTC over stock-index based products by enacting certain legislative proposals that are known as the "Johnson-Shad Accord". *See* Pub. L. No. 97-444, 96 Stat. 2294 (1983); *see also* CFTC and SEC Jurisdictional Agreement: Proposed Legislation, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,332 (Feb. 2, 1982); A11-12. There is no question that in enacting the Accord, Congress fully intended that the SEC would continue to play a critical role in the development of new instruments, including index-based instruments:

> Certain national securities exchanges have proposed to trade, as a package, groups of individual stocks. Since the SEC has the authority to regulate trading in the individual securities composing the group, the Committee believes that it has ample authority to regulate trading in that group. This bill would provide an express statement of that authority.

H.R. Rep. No. 626 (Part 1), 97th Cong., 2d Sess. 10 (1982), *reprinted in* 1982 U.S. Code Cong. & Admin. News 2780, 2788.

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[11] When Congress earlier gave the CFTC exclusive jurisdiction over futures contracts, it expressly added a provision to the CEA to make perfectly clear that the CFTC's exclusive jurisdiction over futures contracts should not be seen as restricting the SEC's role in the development of financial products. That provision, known as the Savings Clause, provides that "[N]othing contained in this section shall (i) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission . . . ." 7 U.S.C. § 2 (1988).

Likewise, the House Committee on Agriculture, which oversees the CFTC, recognized the continuing role of the SEC in these markets:

> The [House Committee on Agriculture] has long recognized and accepted the inherent differences between the futures industry and the securities industry and endorses the concept of separate regulation. Basically, the CFTC will continue its traditional role of regulating markets and instruments that serve a hedging and price discovery function while the SEC will primarily regulate markets and instruments with an underlying investment purpose.

H.R. Rep. No. 626 (Part 2), 97th Cong., 2d Sess. 3 (1982), *reprinted in* 1982 U.S. Code Cong. & Admin. News 2780, 2793.

The Court of Appeals' definition of futurity ignores Congress' intent, and would destroy the balance between the two agencies. Under the court's decision, any instrument that involves the deferral of the right to realize the value of the instrument to a future moment in time could be a futures contract and, therefore, beyond the scope of the SEC. *See* A16. Consequently, allowing the Court of Appeals' decision to stand will fundamentally and improperly alter the delicate balance struck between two federal agencies by Congress, as well as deprive the investing public of the benefits of innovation and competition.

This consequence is all completely unnecessary. A principled and more narrow definition of futurity based on bilateralism, which recognizes that futures contracts are unique financial instruments, would both preserve the authority of the CFTC with respect to the instruments that belong within its jurisdiction and leave the SEC free to foster innovation within its jurisdiction.

It is inconsistent with Congressional intent to define the term futurity, a term not even used in the CEA or the 1982 legislation, so broadly as to undo all the work done by Congress to achieve a proper balance between the CFTC and

the SEC. Yet, the Court of Appeals' decision has this effect. Thus, it is up to this Court to re-examine this issue and to determine if the Court of Appeals overreached in defining the CFTC's jurisdiction so broadly.

Conclusion

For the reasons stated above, the Petition for a Writ of Certiorari should be granted.

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